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DIVIDING HEDGING AND GAMBLING: LEGAL IMPLICATIONS OF DERIVATIVE INSTRUMENTS

By Chao-hung Christopher Chen

The past three decades have seen the emergence in the market of many different types of “derivative instruments”, ranging from futures, forwards, options, and swaps¹ to some other hybrid instruments² or synthetic transactions³. Along with insurance, derivative instruments help market participants not only to hedge various types of risks but also to engage in market speculation. A derivative transaction could serve the purpose of avoiding large losses (i.e. hedging) as well as earning a windfall (i.e. speculation). As such, one question arises: Is there any difference between gambling and derivative trading?

If A and B make a bet (of 100 pounds) on the movement (either up or down) of the FTSE 100 index, it is what we generally call a wager. In contrast, if one wishes to make speculative profits by placing an order in the LIFFE for FTSE 100 index futures, it is regarded as an investment. In addition, if A places a bet of £10 per point (of the FTSE index) with a betting company, it might become a so-called “spread betting”⁴. The above examples share one main scenario - making profits by predicting future movements of the FTSE 100 index. However, when we put them in different

contexts, they may receive different legal treatment.⁵ Furthermore, our perception might change if we vary the context within which the transactions take place. For example, it might be perfectly normal and an accepted part of commercial practice for two banks to enter into an interest rate swap. However, if the same swap occurs between two individuals who enter into this transaction from purely speculative intentions, we might start to doubt whether this transaction makes any sense and whether it looks more like a gamble.

Overall, we can put hedging and traditional gambling contracts on the same spectrum. To some extent, they are all contracts that allow people to make profits or avoid loss from predicting future uncertainties. On this spectrum, certain contracts (such as wagering) have long been labelled as “gambling”. Certain transactions (like insurance) could serve some legitimate purposes and are protected from the prohibitions in gambling laws with established legal doctrines. Derivatives arise in the same context. Like insurance, they could help market participants to hedge against various types of risk. On the other hand, they also open the door for punters to gain speculative profits. Indeed, derivative transactions provide us with many more options than traditional betting, gaming or wagering, etc. This paper does not intend to cover the relationship between financial regulations and gambling regulations. Nor is this paper interested in discussing what should be regulated and how to regulate the financial and gambling market. Instead, this paper plans to answer one basic question that many people might have in mind: what is the difference between risky derivative transactions and gambling contracts?

We could answer this question from several perspectives. This paper will focus on the legal aspect. We should be aware that the meaning of the terms “derivatives” and “gambling” can be difficult to pin down because they are surrounded by ambiguous jargon. This paper intends to pierce this fog and discuss whether derivatives should be understood differently from what we generally perceive as “gambling”. In the following sections, we will first explain the need to make a distinction between derivatives and gambling in the pre-Gambling Act 2005 era. We will then examine certain relevant arguments and legal doctrines, and the new dimension after the new gambling regulatory schemes.

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¹ Many chapters could be written simply to describe what derivatives are and how they work. We can use oil prices as an illustration. An oil forward is a contract to buy (or sell) a certain amount of oil to be delivered in the future with the price fixed when the contract is made (usually, however, these contracts are settled in cash without the oil actually being exchanged). An oil future is the standardised version of forwards and is traded on an organised exchange. An oil option is a right to buy or sell oil in the future (and the option holder has to pay some premiums to the issuer of the option). An oil swap involves a series of exchange of periodical cash flows based on the oil price and a predetermined fixed-rate.

² A typical example of hybrid instrument is the Catastrophe bond (CAT). It is like a normal bond except that the repayment of money is conditional upon the non-occurrence of a catastrophic event (e.g. a hurricane). Higher interest is usually paid as compensation.

³ A synthetic transaction can take many forms and can be extremely complicated. To give a simple example, a synthetic option is not a real option issued by another person, but could be a collection of other derivative instruments (e.g. options or forwards) that mathematically creates a “synthetic” option on the surface.

⁴ See *City Index Ltd v Leslie* [1992] QB 98.

⁵ A wager was rendered unenforceable by the old section 18 of the Gaming Act 1845 and is now legal and enforceable after the Gambling Act 2005. Nevertheless, a wager might still be unenforceable or illegal in other countries. See for example, NY CLS Gen Oblig 5-401. The futures market is now protected by the Financial Services and Markets Act 2000. Spread betting is now also put under the surveillance of the Financial Services Authority. See section 10 of the Gambling Act 2005. However, spreading betting may still constitute illegal wagering or gambling in other countries.

At the beginning, we should be aware of the evils of gambling. Gambling attracts much opposition for various reasons. Gambling, being described as an opportunistic and non-productive behaviour, has received much moral condemnation. Apart from general moral theory, one primary concern with gambling is its association with crime.⁶ Public order is another consideration for the government.⁷ A significant part of gambling regulations or prohibition is to control gambling premises.⁸ In addition, excessive gambling also attracts much attention. Some people do become addicted to gambling, and the addiction can have a negative impact on their family or surrounding people (e.g. astronomical debt). The vulnerability of youngsters and children also raises serious concerns.⁹

The above concerns provide a basis to treat gambling differently from other transactions. Over the past two hundred years, there have been several pieces of legislation being introduced to address various problems in connection with gambling.¹⁰ The same is also true in many other countries. Indeed, gambling has largely been seen as a typical example of an “illegal” contract. Yet, this perception is not accurate. Legal consequences of gambling could range from mere civil unenforceability¹¹ to criminal sanctions.¹² Nevertheless, as long as gambling still invites negative legal consequences, we have to distinguish certain transactions that we deem legitimate from gambling, even though they might contain a certain degree of speculation. Then the question is: how to achieve the goal?

⁶ Whether gambling really leads to more crimes is an issue that requires further empirical studies. See also Royal Commission on Betting, Lotteries and Gaming, *Report of the Royal Commission on Betting, Lotteries and Gaming 1949-1951* (London: HMSO, 1951), p.52.

⁷ Gambling Act 2005, section 1(a).

⁸ For example, the Gambling Act 2005, section 37 and Part 8; the Betting, Gaming, and Lotteries Act 1963, section 1.

⁹ Gambling Act 2005, section 1(c).

¹⁰ To name a few, past legislation includes the Gaming Act 1710, the Gaming Act 1845, the Street Betting Act 1853, the Gaming Act 1892, the Street Betting Act 1906, the Racecourse Betting Act 1928, the Betting and Lotteries Act 1934, the Pool Betting Act 1954, the Betting and Gaming Act 1960, the Betting Levy Act 1961, the Betting, Gaming and Lotteries Act 1963, the Gaming Act 1968, the Lotteries and Amusements Act 1976, the Gaming (Bingo) Act 1985, and the National Lottery Act 1993, etc.

¹¹ See section 18 of the Gaming Act 1845 (abolished by section 334 of the Gambling Act 2005). See also Life Assurance Act 1774, section 1.

¹² For example, the State of Illinois in the U.S. imposes a general prohibition of gambling in the criminal code.

The first step is to define the meaning of the term “gambling”. If certain conduct does not come within the definition of gambling, it is not gambling as a matter of law and thus avoids negative legal consequences of gambling. This task looks simple, but it is indeed a difficult one. As we will explain below, it would be labourious to define “gambling” in clear and unequivocal words. Since we could hardly make a clear definition of gambling, it would be equally difficult to distinguish lawful transactions from gambling by way of a simple definition.

Before the Gambling Act 2005, there was no single definition of “gambling”. Instead, gambling law used various terms, such as betting, wagering, gaming, etc., to describe certain behaviours. The most fundamental type is what we call “wagering”¹³. People can also gamble by playing a game (e.g. a poker game).¹⁴ Betting is a term that could contain a wide variety of gambling behaviours, ranging from fixed-odds betting (with a bookmaker), pool-betting (e.g. a horse race totalisator), to spread betting (of financial indices).¹⁵ Lottery is another common type of gambling. Yet even a lottery may contain several types of games.¹⁶

These concepts could overlap with one another, which makes it more difficult to find a definition. As Lord Wilberforce observed, “[i]t is impossible to frame accurate definitions which can cover every such variety; attempts to do so may indeed be counter-productive, since each added precision merely provides an incentive to devise a variant which eludes it. So the legislation contains a number of expressions which are not, or not precisely, defined: bet, wager, lottery, gaming, are examples of this.”¹⁷

A standard dictionary definition says that gambling means “to play games of chance for money, *esp.* for unduly high stakes; to stake money (*esp.* to an extravagant amount) on some fortuitous event.”¹⁸ A game of chance is to play with future uncertainties, which, in commercial term, might be called “risk”. Thus, if we reduce the discussion to neutral terms, what we generally perceive as gambling is where a person places some stakes and expects to earn some money following an external determining factor (e.g. luck, a football match, a game, or the movement of the

¹³ The classic definition of “wagering” was given by Hawkins J in *Carlill v Carbolic Smoke Ball Company* [1892] 2 QB 484, at 490-491.

¹⁴ Gambling Act 2005, sections 6-8.

¹⁵ Gambling Act 2005, sections 9-13.

¹⁶ For example, apart from the lottery we generally see on TV, a scratch card is called “lottery”. See Gambling Act 2005, sections 14 & 15 and Schedule 2.

¹⁷ *Seay v Eastwood* [1976] 3 All ER 153, at 155.

¹⁸ Oxford English Dictionary Online <<http://dictionary.oed.com/uk>> [accessed 11 August 2006].

market, etc.) with the understanding that he may lose his stakes if things do not go as he wishes.

The same is also true in trading derivatives. For example, a fixed-for-floating interest rate swap, in essence, is similar to a series of bets on the movement of interest rate. Although an interest rate swap can be seen as a series of set-offs of fixed-rate payments against floating payments (based on an agreed notional amount), the result of an interest rate swap is as if the floating rate payer will pay only if the floating rate is higher than the fixed rate, and *vice versa* for the fixed rate payer. Thus, an interest rate swap might be seen as a series of bets on interest rates. The fixed-rate payer bets that the market interest rate would be higher than the fixed rate, and *vice versa* for the floating rate payer. As Lord Goff observed, “[i]nterest rate swaps can fulfil many purposes, ranging from pure speculation to more useful purposes such as the hedging of liabilities. They are in law wagers, but they are not void as such because they are excluded from the regime of the Gaming Acts by section 63 of the Financial Services Act 1986.”¹⁹

Instead of making a uniform definition to describe “gambling”, the Gambling Act 2005 only lists a range of conducts that constitute regulated “gambling”.²⁰ This approach is practical, but it does not make clear what is gambling in nature and what is not. The same is also true for subcategories such as betting, gaming, and wagering, etc. Statutory language provides guidance for regulatory purposes, but they do not provide a dividing line.

Approach II: Market Function of Speculation

Another theory is to distinguish “speculation” from “gambling”. The reason is that speculation can help to make the market (i.e. to meet the demand of hedgers) while gambling cannot.²¹ This theory particularly applies to the financial and commodity markets.²² This

¹⁹ *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, at 680. In *Morgan Grenfell v Welwyn Hatfield District Council*, Hobhouse J also observed that “[s]ince they provide for the payment of differences they are capable of being entered into by two parties with the purpose of wagering upon future interest rates.” [1995] 1 All ER 1, at 8.

²⁰ Gambling Act 2005, section 3.

²¹ David Mier, *Regulating Commercial Gambling: Past, Present, and Future* (Oxford: Oxford University Press, 2004), p. 6.

²² Aranson and Miller distinguished insurance, speculation, and gambling as the three forms of activities with explicit assessment of risk. They seemed to compare “speculation” with the kind of risk-taking activities in the futures market. Apparently, the meaning of “speculation” is more limited if we confine it to futures markets. Peter H. Aranson & Roger LeRoy Miller, “Economic Aspects of Public Gaming”, 12 Conn. L. Rev. 822 (1980), 831, 833-835.

approach is persuasive if we contrast speculative futures trading in an exchange and a bucket shop transaction (i.e. off-exchange futures trading). Indeed, speculators play an important role in meeting the demands of risk-averse parties. Without their presence, the volume of trading could be greatly reduced and transaction costs might prevent a party from finding a suitable counterparty to conduct hedging.

There are three points we can make regarding this argument. First, the market-making function does not change the fact that market speculation is a kind of behaviour to make opportunistic profits. Whether the law should allow a certain degree of speculation in the market because of the market-making function is another matter. Secondly, gambling could also provide some market function. With the help of betting exchanges, a bookmaker can also hedge his own risk or make the odds market by betting with another bookmaker.²³ Arguably, a bookmaker is like a market maker in the betting market in this situation. He can also be a bridge between two punters. Thirdly, speculation, though necessary in the financial market, might not be allowed beyond a certain boundary.²⁴ Like gambling, market speculation could still be excessive. How much speculation should be tolerated in the market requires further analysis. Thus, it is not convincing to distinguish speculators and gamblers merely from their market-making function. After all, speculation in the market and gambling on financial markets are both opportunistic transactions which aim to make profits from market fluctuation.

In sum, as far as market is concerned, public policy may dictate that a certain degree of speculation should be tolerated. Similarly, gambling could well be allowed to boost local economy²⁵ or for the purpose of promoting good causes²⁶. In addition, market speculation, if not regulated by the Financial Services Authority, might still come within the ambit of Gambling Act 2005.²⁷ We do not doubt that speculation could serve certain market-making function. Nevertheless, this function alone does not itself distinguish “market speculation” from gambling. A derivative instrument, if used for speculation, is not different from gambling.

²³ See below note 30.

²⁴ For example, the US commodity regulations impose a daily limit a trader can trade in a futures exchange. 7 USCA 6a & 6i; 17 CFR 150.2.

²⁵ In the United States, casinos are sometimes allowed in order to boost local economy (e.g. in the State of Nevada) or to support minority (e.g. casinos operated by Indians in California).

²⁶ For example, the National Lottery has so far raised more than 18 billion pounds. See <http://www.national-lottery.co.uk/player/p/goodcauses/fundraising.do> [accessed 20 October 2006].

²⁷ Gambling Act 2005, section 10(2).

Approach III: Justifying Hedging and Insurance: Conceptual Attempts

Instead of defining “gambling”, another way is to justify certain transactions as lawful business so that we can temporarily ignore the meaning of gambling. While gambling attracts much criticism, judges seem to take “hedging” as a legitimate commercial purpose.²⁸ Compared with extra risk taking, risk avoidance receives less moral condemnation. The long history of insurance law suggests that minimising the impact of loss originating from a future event is acceptable. Although in theory the same risk is merely redistributed to other people, there is more “positive” value in reducing the impact of future hazards from the hedger’s view. A justification for hedging and insurance could come from three aspects: conceptual arguments, proprietary connections and the subjective intention of both parties. Here we will explore the conceptual level.

First, one can make an argument that an uncertainty in gambling can otherwise cause no harm, while in a hedge a person is exposed to potential loss if the risk is realised.²⁹ Though this statement might be true in most circumstances, it is not always correct. The outcome of gambling does not always depend on luck, but is sometimes determined by the result of an external factor that could cause harm. Take sports betting as example. The owner of a losing horse might have some incentives to compensate for his expenditures should his horse not win a race. Is it not hedging if the horse owner opts for fixed odds betting or spread betting to cover his potential loss? Moreover, a punter who places a bet on a sporting event may have incentives to hedge his bet by simply making a contrary bet. That is what a bookmaker is doing.³⁰ Therefore, although we may distinguish a lottery or a pure wager on the basis that the uncertainty can otherwise cause no harm, there is a grey area where hedging and gambling cross each other.

Secondly, another argument is that by hedging a person is exporting uncertainty in return for certainty, whereas by gambling a punter actively and intentionally increases his own risk exposure. This statement is

probably true when we try to describe certain types of behaviour, but it misses the point that hedging is frequently itself a risky transaction. A hedger may have to take extra risks in order to hedge another transaction.³¹ Indeed, a hedger faces two situations: to hedge a risk or not to hedge. On the one hand, if he decides to find a cover for potential loss, more than likely he has to pay something in return (e.g. an insurance premium). If the unfavourable event does occur in the future, the gain in the hedge is used to cover his loss. In contrast, if the event does not occur, with hindsight the money he pays for the hedge virtually becomes a loss. Thus, a hedge contains a certain degree of speculation in itself, even though it is used to cover another risk. Even with careful analysis in advance, a deal intended as a hedge might still result in huge losses.³²

In addition, one can use a typical gambling transaction (e.g. spread betting) to reach the same hedging goals. Whether a transaction looks like hedging or tilts toward gambling is not determined by whether a party exchanges uncertainties for certainties (or *vice versa*), but rather by how the general public perceives certain types of behaviour and how a party uses a particular transactional structure to achieve his goals. The above-mentioned arguments, though promising in some regards, fail to provide a clear answer.

Approach IV: Proprietary Interests: Insurable Interest Test

As Lord Mansfield stated, “insurance is a contract upon speculation”³³. The development of insurance law has coincided with the increasing control over gambling. Since insurance has great resemblance to betting on a person’s life or property, the insurable interest test has been developed to separate lawful insurance policies from wagering or gaming. An insurance policy is not enforceable if the assured does not have “insurable interest” in the subject matter of the insurance policy. Regardless of the question whether derivatives might be defined as insurance, the insurable interest test gives us some insight of how to distinguish lawful contracts from gambling. If, for example, we focus on property insurance, then we need to examine the proprietary interests a person holds in relationship to a property

To constitute an “insurable interest”, “a person is interested ... where he stands in any legal or

²⁸ See *City Index v Leslie* [1992] QB 98, at 112 (*per* Leggatt LJ); *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669, at 680 (*per* Lord Goff).

²⁹ Peter H. Aranson & Roger LeRoy Miller, “Economic Aspects of Public Gaming”, 12 Conn. L. Rev. 822 (1980), 834.

³⁰ A bookmaker who receives bets from punters can actually place a bet in a betting exchange or with another bookmaker (a hedging bet) so as to shift his risk exposure from the punters’ bets to other bookmakers. This situation is somewhat similar to the reinsurance market or back-to-back swaps. See David Mier, *Regulating Commercial Gambling: Past, Present, and Future* (Oxford: Oxford University Press, 2004), p. 6 note 23.

³¹ At least, a hedger is still exposed to the credit risk of the counterparty.

³² See for example, *Procter & Gamble Co v Bankers Trust Co*, 925 F.Supp. 1270 (S.D.Ohio 1996).

³³ *Carter v Boehm* (1766) 3 Burr 1905. See also the Preamble of the Life Assurance Act 1774.

equitable relation to ... any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss, or damage thereto, or by the detention thereof, or may incur liability in respect thereof.”³⁴ In short, an insurable interest might be seen as an “insurable relationship”.³⁵ A policy is less likely to resemble gambling if the insured has a relationship with the person or the thing being insured. Indeed, wagering or gambling continues to be a major concern.³⁶ The insurable interest test, along with the indemnity nature of property insurance³⁷, ensures that an insurance policy would not become a wager because an assured must suffer certain kinds of loss to his property in order to claim compensation from an insurer, and thus reduces the chance of moral hazards.

To determine whether an assured has an insurable interest in the property insured, two tests have been devised. The traditional way is to define an insurable interest by legal or equitable ownership, and is known as the “legal interest” test.³⁸ On the other hand, the “factual expectancy” test has been developed to cope with the restrictiveness of the legal interest test.³⁹ The factual expectancy test allows a person to insure his business or future proprietary interests, even though he is not a legal or equitable owner of the property. The difference between the two approaches could best be illustrated by cases regarding insurance of a company’s property by its shareholders.⁴⁰ Although the factual expectancy test seems to be more popular in other common law jurisdictions,⁴¹ the English law still insists on the legal interest test.⁴²

In relationship to derivatives, we find that the indemnity nature and the insurable interest test are not applicable. Unlike insurance, modern derivatives are more about market fluctuation than hazards associated with a specific person or property. Nor does the modern market hedging require a hedger to hold the underlying commodities, securities or whatever assets the risk of which he intends to hedge against. Price differences are the subject-matter rather than proprietary damage. From a more practical point of view, most of the current derivatives market would simply wither away if we expect a hedger to be the legal or equitable owner of the underlying assets.

The factual expectancy test seems to be a better fit. Nevertheless, the “factual expectancy” in property insurance is still constructed on certain kinds of proprietary interest, if not as strict as legal or equitable ownership. Thus, in a property insurance policy we can examine the expectation of the insured based on his interest in a certain property or a project.⁴³ In contrast, the same basis might not be applicable to modern hedging. For example, while buying or selling futures for grain in the current season seems to fit reasonably well into the factual expectancy test, hedging grain of the next season (or even the season after), which might not be seeded yet, looks more dubious. Virtually anything can be justified if the “factual expectancy” is laid out too broadly.

Perhaps what is more revealing is the indemnity nature of property insurance and the meaning of “loss”. The most straightforward reference for “loss” is damage to property. However, damage can appear in various forms. It may mean the cost of restoring the property to the original condition⁴⁴, the drop in value of the damaged property⁴⁵, loss of profit or economic loss⁴⁶, price differences after the breach of a contract of sale⁴⁷, and even damage for psychiatric illness.⁴⁸ In insurance law, the “loss” may not go as far as emotional damage, but may contain damage, expenses and loss of profit.⁴⁹

³⁴ Marine Insurance Act 1906, section 5(2).

³⁵ See Bertram Harnett & John V. Thornton, “Insurable Interest in Property: A Socio-economic Re-evaluation of A Legal Concept”, 48 Colum. L. Rev. 1162 (1948); Malcolm Clarke, *Policies and Perceptions of Insurance: An Introduction to Insurance Law* (Oxford: Clarendon, 1997), p. 20.

³⁶ The term “wager” or “wagering” was used frequently in cases regarding insurable interests. For example, see *Wilson v Jones* (1867) LR 2 Ex 139; *Moran, Galloway & Co v Uzielli* [1905] 2 KB 555; *Feasey v Sun Life Assurance Co of Canada* [2002] 2 All E.R. (Comm) 492; *O’Kane v Jones (The “Martin P”)* [2004] 1 Lloyd’s Rep 389.

³⁷ Property insurance is a contract of indemnity in nature, which means that a policy is issued to cover real loss of an assured. If there is no loss, there is no compensation. In contrast, a life assurance is described as a contract of contingency.

³⁸ See *Lucena v Cranford* (1806) 2 Bos & PNR 269 (per Lord Eldon).

³⁹ *Id.*, at 302-3 (per Lawrence J).

⁴⁰ Cf. *Macaura v Northern Assurance* [1925] AC 619; *Wilson v Jones* (1867) LR 2 Ex 139; and *Constitution Insurance Company of Canada v Kosmopoulos* (1847) 34 DLR (4th) 208.

⁴¹ See generally Lowry & Rawlings, “Re-thinking Insurable Interest” in *Commercial Law and Commercial Practice*, ed. by Sarah Worthington (Oxford: Hart, 2003); Julie-Anne Tarr,

Disclosure and Concealment in Consumer Insurance Contracts (London: Cavendish, 2002).

⁴² See *Macaura v Northern Assurance* [1925] AC 619; See also Lowry & Rawlings, *id.*, p. 347-354.

⁴³ For example, *Tomlinson (Hauliers) Ltd v Hepburn* [1966] 1 All ER 418 (cigarettes in a warehouse and the carrier); *Petrofina (UK) Ltd v Magnaload Ltd* [1984] QB 127; [1983] 2 Lloyd’s Rep 91 (subcontractor in a building project); *Mark Rowlands Ltd v Berni Inns* [1986] QB 211 (tenant un-named in the policy and building insurance).

⁴⁴ See *Bacon v Cooper (Metals) Ltd* [1982] 1 All ER 397.

⁴⁵ The relationship between the costs to repair and the differences in value is not always an easy one. See *Ruxley Electronics and Construction Ltd v Forsyth* [1996] AC 344.

⁴⁶ See *Hedley Byrne & Co v Heller & Partners* [1964] AC 465.

⁴⁷ Sale of Goods Act 1979, sections 50 & 51.

⁴⁸ For example, *Page v Smith* [1996] 1 AC 155; *White v Chief Constable of South Yorkshire* [1999] 2 AC 455.

⁴⁹ See *Wilson v Jones* (1867) LR 2 Ex 139.

In contrast, the “loss” that derivatives could hedge against is different in certain regards. First, the “loss” that a hedge would cover does not necessarily occur following an event. The payment in an index forward or an interest rate swap is determined by market movement rather than an event causing the “loss”. The so-called credit derivative comes closest to insurance or event-caused “loss”. In a typical credit default swap (CDS) for a corporate bond, if the reference event (e.g. non-payment of interests) occurs, the risk-buyer has to pay the loss in value of the bond or simply buys the bond from the risk-seller at the par value. It looks similar to insurance because the liability of one party hinges upon the happening of an event. However, what differentiates a CDS from a credit insurance policy, a contract for guarantee or a security interest is that is that the payment under a standard CDS refers to the differences between the face value of the bond and its current market price rather than the unpaid obligation of the principal debtor.

Secondly, in the hedging world, the “loss” frequently means merely the price differential. The “loss” might be virtual because it exists only on paper. For example, a shareholder might find his overall investment shrinking if prices of the shares in his portfolio drop. The price differences can be counted as a “loss” on paper or for accounting or tax purposes. However, as long as the shareholder still holds the shares, the “loss” is not realised. The book loss might later become a gain if the share price moves up again. In another example, a buyer who purchases Brent crude oil in August 2005 in the spot market might find the price is much more expensive than 6 months earlier (if he had a choice to buy on February 2005). It is a loss in the sense that the buyer makes a bad decision as to the purchase time, but it is not close to any legal meaning of “loss” as described above.

Thirdly, frequently in a hedging contract the payment is not conditional upon the suffering of “loss”. Price differences are paid as it is stated in the contract. The concept of hedging may be closer to “compensation” than “indemnity”. From a market participant’s point of view, it is hard to imagine that a hedge exists only to indemnify the damages he has suffered. Indeed, the concept of “loss” in the context of modern hedging is not limited to property damage or the loss of profits following an event. It is closer to a life assurance whose purpose is to compensate the assured (or other beneficiaries) for future contingencies than it is to property insurance, which indemnifies the “loss” to a property. Nevertheless, there is a much stronger moral hazard arguments (e.g. the increased chance of murder of the assured) in the context of life assurance that cannot be applied by analogy to derivative instruments. Thus, life assurance and derivatives are not totally comparable.

In sum, the insurable interest test has been developed in the special context of insurance, whereas

a policy is described as a contract of indemnity (for property insurance) and an established insurer acts as a risk-buyer. This context cannot be applied to other hedging contracts. The factual expectation test, though broader than the legal interest test, still refers to damage to property. Modern hedging practice is apparently wider than merely property damage and refers to broader economic losses. Regardless of the problem whether derivatives are insurance, the insurable interest test developed in property insurance is too narrow to suit modern derivatives trading. Whether the Gambling Act 2005 might affect the insurable interest test in insurance law is another issue that might be developed in the future.

Approach V: Purpose of a Transaction

Next, we need to turn to the intention of both parties. For example, to determine whether a contract was unenforceable under the old section 18 of the Gaming Act 1845, both parties had to intend the transaction to be gaming or wagering.⁵⁰ If the transaction served any other legitimate purpose, it was not a gaming or wagering contract.⁵¹ It must be that all parties to a transaction intend it to be gaming or wagering. Thus, in the stock market, even if the investor intends to “gamble” on the market without any intention of taking the shares, it does not make the transaction a gamble as long as the broker intends it to be a real sale.⁵²

While being flexible, the intention or purpose test still has some shortcomings. On the one hand, it is subject to evidence and can sometimes be quite arbitrary. Given the relatively uncertain definition of “gambling”, the intention to hedging, gambling, wagering or gaming lacks clarity for the same reason. On the other hand, should the court examine the real intention or purpose of parties or simply look at the purported ones?

In addition, a transaction might have multiple purposes. English courts seem to take a practical approach to vindicate a transaction as long as there is another legitimate purpose in addition to gambling.⁵³

⁵⁰ See *Carlill v Carbolic Smoke Ball Company* [1892] 2 QB 484; *Universal Stock Exchange v Strachan* [1896] AC 166; *City Index Ltd v Leslie* [1992] QB 98; *Morgan Grenfell v Welwyn Hatfield District Council* [1995] 1 All ER 1.

⁵¹ *Earl Ellesmere v Wallace* [1929] 2 Ch 1, at 25 (*per* Lord Hanworth).

⁵² See *Thacker v Hardy* 4 QBD 685 (1878); *Universal Stock Exchange v Strachan* [1896] AC 166.

⁵³ See *Carlill v Carbolic Smoke Ball Co* [1892] 2 QB 484; *Universal Stock Exchange, Ltd v Strachan* [1896] AC 166; *City Index Ltd v Leslie* [1992] QB 98; *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1

However, what if the legitimate purpose is so marginal in a transaction that it is merely a screen for gambling? Should the court balance the weight of different purposes? A more objective approach to intention might solve this problem by reviewing the totality of circumstances rather than merely relying on what one party thinks. Such an approach might also help to put more substance into the purpose of hedging. However, while we may recognise the combination of speculation and hedging in one transaction, it is eventually up to legislators or judges to decide how much speculation is acceptable and how much will come within the range of so-called “gambling”.

The search for the exact meaning of gambling (of any kind) and the intention to gamble is like a tautology. It is hard to define an intention to gamble because it is not clear what gambling is, and on the other hand it is difficult to define a clear range of transactions as “gambling” because it partly depends on the intention of both parties in such transactions. It might be easy in some typical cases, but it might be a problem if new contracts appear. However, while the Gambling Act 2005 does not make any distinction between hedging and gambling (or betting, gaming, etc.), the intention or purpose test is still the most flexible option if we need such a distinction.

Conclusion: After the Gambling Act 2005?

In the above sections, we have illustrated several approaches to distinguish lawful hedging derivative transactions from gambling. However, no one single approach is perfect to suit the derivatives market. On the one hand, gambling is difficult to define, and thus is difficult to be distinguished from derivatives trading generally. On the other, derivative instruments could be used to hedge risks as well as to bet on market movement. Both purposes could co-exist in a transaction at the same time. Thus, it is difficult to classify a single class of derivative transactions as lawful hedging without including speculative deals.

The Gambling Act 2005 does change the scene. There is no longer a need to force a derivative transaction out of the concept of “gambling” in order to avoid negative legal consequences. Instead, the focus now may shift to how to control speculative transactions without compromising their hedging functions. Yet, our discussion is still meaningful for several reasons in the post-Gambling Act 2005 era.

First, legal risks remain where most countries other than the U.K. still penalise gambling. The Gambling Act 2005 could not provide a perfect safe harbour to a truly international and well-connected derivative market. We still need a valid argument to distinguish certain transactions from what we see as

“gambling”. Secondly, while hedging seems to be accepted as legitimate, speculation is not. Even if gambling becomes legal, it does not mean that speculation is always desirable.⁵⁴ Dividing derivative transactions intended for hedging from purely speculative ones may still be meaningful under the financial regulation.

Thirdly, the Gambling Act 2005 creates a comprehensive licensing scheme for those who plan to carry on a gambling business. Thus, what is gambling (and what is not) remains an important issue for this regulatory purpose. As we have argued above, the definition of “gambling” in the Gambling Act 2005 is broad enough to cover a wide range of speculative derivative transactions. While gambling laws do not provide a safe harbour for those transactions that serve “hedging” or other legitimate purposes, a conceptual distinction might be necessary.

Fourthly, the financial market innovates quickly. So does the gambling industry. More “financial betting” might arise with the same financial technique. It is necessary to realise the similarity or difference between derivatives and gambling so that we can fully assess further regulatory issues.⁵⁵ Lastly, studying whether derivatives are a type of gambling would help us to recognise the value of derivatives. From here, we may then appreciate both how useful derivative transactions might be and at the same time how much damage they might cause.

If we accept that market speculation and gambling are in essence the same thing, we have to work on the difference between hedging and speculation/gambling to identify derivative transactions for hedging (or in other words, we are still interested in how to define “hedging”). As we argued above, the insurable interest test in insurance law attempts to distinguish insurance from gambling by examining the proprietary or personal relationship of the assured. However, this approach is too limited to suit the modern hedging market. The intention test (Approach V) still seems to be the best option. Nevertheless, more substance might have to be injected to create a more comprehensive test rather than relying on the subjective intention of either or both parties. In short, we have to put more efforts on constructing what is a “hedge” in order to give the “intention to hedge” a more substantive meaning in law.

⁵⁴ For example, the U.S. law imposes a daily position trading limit in the futures market unless one can prove that he is a *bona fide* hedger. See 7 USCA 6a and 17 CFR 150.1 *et seq.*

⁵⁵ In fact, before the Gambling Act 2005 spread betting business was subject to dual regulatory control under both gambling laws (as a bookmaker) and financial regulations. The Gambling Act 2005 has resolved this overlap by leaving spread betting to the Financial Services Authority. Nevertheless, new problems may continue to arise when new “gambling” products are created with techniques learnt from derivatives.

English law takes the lead in legalising private gambling and removes the legal risk of off-exchange derivative transactions. Other major countries have not followed. As new derivative instruments continue to be created into the market, we are looking forward to further development in both the gambling law and financial law to create more legal certainty to major market players and ordinary punters.

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